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Bank director remuneration: Why no downside risk?

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Thought Leadership in the Financial Sector

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In this Financial Policy Brief, Professor Kevin Davis asks the question of why bank board remuneration is not included in the list of limited distributions if a bank fails to meet the capital conservation buffer applied as part of the Basel capital requirements. Since the board is ultimately responsible for capital adequacy planning, it is argued that they should also bear some of the costs if that planning is deficient. While board remuneration policies typically do not link non-executive director remuneration to bank performance, it is not apparent that some downside linkage is not optimal policy.

In 2010 a capital conservation buffer was introduced as part of Basel 3. It requires that if a bank's capital ratio falls below a specified level, the bank is limited in terms of certain distributions (such as dividends and staff bonus payments) it can make.

But one form of payment not affected by this requirement is payments to directors, who are ultimately responsible for the performance of the bank. There are good reasons for changing the buffer requirements to also limit the ability of the bank to renumerate directors if a capital shortfall occurs.

Background: The Capital Conservation Buffer (CCB)

The CCB specifies that banks must maintain a Common Equity Tier 1 capital ratio at least 2.5 percentage points above the minimum requirement of 4.5 per cent or other Prudential Capital Ratio (PCR) determined by the regulator. This implies an overall minimum (PCR+CCB) of 7 per cent – or higher in cases where there are other capital charges (or higher PCR) applied by the regulator (such as in the case of systemically important banks). Failing to meet this requirement means that the bank faces limits on its ability to make distributions in the form of dividends and/or bonus payments to staff.

The restrictions increase in severity as the capital shortfall relative to (PCR+CCB) increases. In some jurisdictions this is applied by calculating a *Maximum Distributable Amount (MDA)*, which acts as an upper bound on distributions. The MDA is calculated as some proportion (between 0 and 0.6) of profits in the current period, where the proportion falls as the capital shortfall increases.

In Australia, under APRA's Prudential Standard APS 110, the approach is equivalent but expressed as a Minimum Conservation Ratio (MCR). If the shortfall is less than 25 per cent of CCB (that is, the capital ratio is above 6.375 per cent (equal to 4.5 + ¾ (2.5)) for a bank where PCR = 4.5 per cent, the minimum conservation ratio is 40 per cent of earnings (ie up to 60 per cent can be distributed). The MCR increases in a stepped fashion as the shortfall increases, until at a shortfall of 75 per cent or more, no distributions can be made. Indeed, at that point (5.25 per cent) the bank will hit the trigger point for mandatory conversion of AT1 preference share instruments to be mandatorily converted (“bailed-in”) into equity (and APRA may have pulled the Point of Non-Viability trigger prior to that).

The distribution limits apply to dividends and share buybacks, discretionary distributions on AT1 instruments and discretionary bonus payments to staff. Earnings are calculated as profits before both tax and planned distributions of the sort which may be restricted.

The rationale for the CCB “is to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress. While banks are allowed to draw on the buffer during such periods of stress, the closer their regulatory capital ratios approach the minimum requirement, the greater the constraints on earnings distributions. This framework will reinforce the objective of sound supervision and bank governance and address the collective action problem that has prevented some banks from curtailing distributions such as discretionary bonuses and high dividends, even in the face of deteriorating capital positions.”[1]

Why exclude director remuneration from restrictions on distributions?

Ultimately, bank boards carry responsibility for bank performance. Indeed the OECD Corporate Governance Principles[2] assert that it is “good practice for boards to develop and disclose a remuneration policy statement covering board members and key executives. Such policy statements specify the relationship between remuneration and performance, and include measurable standards that emphasise the longer run interests of the company over short term considerations.”

A common feature of board remuneration policies of Australian banks is that non-executive director (NED) remuneration is not linked to bank performance.[3] One bank argues that this is done “so that independence and impartiality is maintained” (ANZ, remuneration report, Annual Report 2014, p40). Another argues that “as the Board’s focus is on strategic direction, long-term performance and the creation of shareholder value, fees for Non-executive Directors are

[1] Basel Committee Press Release *Group of Governors and Heads of Supervision announces higher global minimum capital standards* 12 September 2010. http://www.bis.org/press/p100912.htm

[2] G20/OECD (2015) *G20/OECD Principles of Corporate Governance* http://www.oecd-ilibrary.org/governance/g20-oecd-principles-of-corporate-governance-2015_9789264236882-en

[3] Most Australian bank boards have primarily non-executive members, other than the CEO and maybe one other executive director.

not related to the Group's short-term results and Non-executive Directors do not receive performance based remuneration" (Westpac Annual Report 2016, p54).

Somewhat paradoxically, unless one thinks that the bank share price is unrelated to short term performance, many banks expect NEDS to have a significant equity shareholding in the bank. However, such investments involve two-way risk (upside and downside) from share price movements and thus (unlike option or performance related payments) do not have obvious consequences for risk taking. These are often in the order of $0.5 million or thereabouts in the case of the major bank directors.

There are most likely good grounds for not providing an upside linkage of NED remuneration to short term bank performance. With limited downside linkage, it could be argued that doing so could induce increased risk taking strategies. But imposing a downside linkage has the opposite, and for banks prudentially desirable, effect of inducing more risk averse decision making. Including NED remuneration in the restricted payments if the capital conservation buffer is breached is one way of doing this.

Perhaps more importantly, bank boards are responsible for capital planning and oversight of a bank's risk management systems. A bank unable to meet the capital conservation buffer has clearly experienced poor performance in at least one of these duties. For that the Board should be held accountable, and including board remuneration in the list of restricted payments goes part way to achieving that.

Implementing inclusion of board remuneration in the CCB requirements

If board remuneration is to be included in the list of restricted payments, a number of practical issues would need to be resolved. First, there would need to be specific policy guidance on the priority of this restriction over the others (staff bonuses and dividends and so forth).[4] At the moment, the choice of what gets restricted is a decision of the Board. Second, there would need to be requirements to prevent avoidance of the restriction due to timing of Board remuneration payments. No doubt there are others.

It might be suggested that restricting payments to directors in these circumstances is draconian (taking away their income) and unnecessary (since their reputations and future employment prospects will suffer). Neither argument has much merit. Very few, if any, bank directors would have that board position as their only source of income – and most could be

[4] A priority ranking exists in the event of a company's insolvency. Whereas employee claims have a statutory priority over other unsecured creditors under Section 556 of the Corporations Act, directors are excluded from this condition and only rank equally with other unsecured creditors.

expected to have significant accumulated wealth from the careers that led to them being appointed to the roles. And while reputations and prospects might suffer, there is not a lot of evidence that this has occurred in the past.

In summary, there are strong arguments for, and little against, including board remuneration in the list of restricted distributions by a bank which breaches its capital conservation buffer.

This Financial Policy Brief was prepared by Professor Kevin Davis, Research Director of the Australian Centre for Financial Studies

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